

CHAPTER 1

FINANCIAL STATEMENTS PRESENTATION



What Is Profit or Loss?

Profit or loss is the total of an entity's revenues and expenses, not including any components of other comprehensive income (see the next question). It is also known as *net income*.

Total comprehensive income is the combination of profit or loss and other comprehensive income.



What Is Other Comprehensive Income?

Other comprehensive income contains all changes including financial items that are not permitted in profit or loss. Items that you should insert in other comprehensive income include:

- Available-for-sale securities fair value changes that were previously written down as impaired
- Available-for-sale securities unrealized gains and losses
- Cash flow hedge derivative instrument gains and losses
- Debt security unrealized gains and losses arising from a transfer from the available-for-sale category to the held-to-maturity category
- Foreign currency gains and losses on intra-entity currency transactions where settlement is not planned or anticipated in the foreseeable future
- Foreign currency transaction gains and losses that are hedges of an investment in a foreign entity
- Foreign currency translation adjustments
- Pension or post-retirement benefit plan gains or losses
- Pension or post-retirement benefit plan prior service costs or credits

4 Financial Statements Presentation

- Pension or post-retirement benefit plan transition assets or obligations that are not recognized as a component of the net periodic benefit or cost

It is acceptable to either report components of other comprehensive income net of related tax effects, or before related tax effects with a single aggregate income tax expense or benefit shown that relates to all of the other comprehensive income items.

An example of a possible format for reporting other comprehensive income in the income statement is:

EXAMPLE 1.1	
GUTTERING CANDLE COMPANY STATEMENT OF INCOME AND COMPREHENSIVE INCOME FOR THE YEAR ENDED DECEMBER 31, 20X1	
Revenues	\$1,000,000
Expenses	<u>800,000</u>
Net income	<u>200,000</u>
Other comprehensive income, net of tax:	
Foreign currency translation adjustments	10,000
Unrealized gains on securities:	
Unrealized holding gains arising during the period	\$12,000
Less: reclassification of gains included in net income	<u>(3,000)</u>
	9,000
Defined benefit pension plans:	
Net loss arising during the period	(2,000)
Prior service cost arising during the period	(4,000)
Less: amortization of prior service cost included in net periodic pension cost	<u>1,000</u>
	<u>(5,000)</u>
Other comprehensive income	<u>14,000</u>
Comprehensive income	<u>\$ 214,000</u>

You should list the total of other comprehensive income for each reporting period to a component of equity

What Information Is Included in a Complete Set? 5

that is displayed separately from retained earnings and additional paid-in capital in the balance sheet, and call it *accumulated other comprehensive income*. An example showing the placement of this line item within the equity section of an entity's balance sheet follows:

EXAMPLE 1.2	
Equity:	
Common stock	\$1,000,000
Paid-in capital	10,000
Retained earnings	450,000
Accumulated other comprehensive income	25,000
Total equity	<u>\$1,485,000</u>

If an item listed in other comprehensive income becomes a realized gain or loss, you then shift it out of other comprehensive income and into net income or loss. This can happen, for example, when you sell an investment security for which you already recorded an unrealized gain in other comprehensive income. At the point of sale, this is now a realized gain, which shifts into net income. You can display this reclassification adjustment either on the face of the financial statements, or in the accompanying notes.

Total comprehensive income is the combination of profit or loss and other comprehensive income.



What Information Is Included in a Complete Set of Financial Statements?

All of the following financial reports should be included in a complete set of financial statements for a reporting period:

Statement	Description
Balance sheet (Statement of financial position)	Contains all asset, liability, and equity items
Statement of comprehensive income	Contains all income and expense items
Statement of changes in equity	Reconciles changes in equity for the presented periods
Statement of cash flows	Displays all cash inflows and outflows from operating, financing, and investing activities
Notes	Summarizes accounting policies and explanatory information

6 Financial Statements Presentation

You should clearly identify these financial statements and distinguish them from other information presented in the same report, so that users will be more likely to understand which documents within the report adhere to specific accounting standards.

You should include in the financial statements a prominent display of the name of the reporting entity (and note any change in it from the preceding reporting period), whether the statements are for a single entity or group of entities, the period covered by the statements, and the level of rounding used to present amounts. This information is usually most easily presented in column and page headers.



What Line Items Do I Include in the Balance Sheet?

There is no specific requirement for the line items to be included in the balance sheet. The following line items, at a minimum, are normally included in the balance sheet:

Assets

- Cash and cash equivalents
- Trade and other receivables
- Investments
- Inventories
- Property, plant, and equipment
- Intangible assets
- Assets held for sale

Liabilities

- Trade and other payables
- Accrued expenses
- Current tax liabilities
- Other financial liabilities
- Liabilities held for sale

Equity

- Capital stock
- Additional paid-in capital
- Retained earnings

You should add headings and subtotals to this minimum set of information if it will improve a user's understanding of the financial statements. You should add other line items when their size, nature, or function makes separate presentation relevant to the user.

What Line Items Do I Include in the Balance Sheet? 7

EXAMPLE 1.3

Holystone Dental Corporation presents its balance sheet in the following format:

**HOLYSTONE DENTAL CORP. STATEMENT OF
FINANCIAL POSITION**

(000s)	as of 12/31/x2	as of 12/31/x1
ASSETS		
Current assets		
Cash and cash equivalents	\$ 270,000	\$ 215,000
Trade receivables	147,000	139,000
Inventories	139,000	128,000
Other current assets	15,000	27,000
	571,000	507,000
Non-current assets		
Property, plant, and equipment	551,000	529,000
Goodwill	82,000	82,000
Other intangible assets	143,000	143,000
	776,000	754,000
Total assets	\$1,347,000	\$1,263,000
LIABILITIES AND EQUITY		
Current liabilities		
Trade and other payables	\$ 217,000	\$ 198,000
Short-term borrowings	133,000	202,000
Current portion of long-term borrowings	5,000	5,000
Current tax payable	26,000	23,000
Accrued expenses	9,000	13,000
Total current liabilities	390,000	441,000
Non-current liabilities		
Long-term debt	85,000	65,000
Deferred taxes	19,000	17,000
Total non-current liabilities	104,000	82,000
Total liabilities	494,000	523,000
Shareholders' Equity		
Capital	\$ 100,000	\$ 100,000
Additional paid-in capital	15,000	15,000
Retained earnings	738,000	625,000
Total equity	853,000	740,000
Total liabilities and equity	\$1,347,000	\$1,263,000

8 Financial Statements Presentation

**When Do I Present Information as Current or Non-Current?**

You should classify all of the following as current assets:

- *Cash*. Cash that is available for current operations, and any short-term, highly liquid investments that are readily convertible to known amounts of cash and which are so near their maturities that they present an insignificant risk of value changes. Do not include cash whose withdrawal is restricted, to be used for other than current operations, or segregated for the liquidation of long-term debts.
- *Inventory*. Includes merchandise, raw materials, goods in process, finished goods, operating supplies, and maintenance parts.
- *Accounts receivable*. Includes trade accounts, notes, and acceptances that are receivable. Also include receivables from officers, employees, affiliates, and others, if they are collectible within a year. Do not include any receivable that you do not expect to collect within 12 months.
- *Marketable securities*. Includes those securities representing the investment of cash available for current operations, including trading securities.
- *Prepaid expenses*. Includes prepayments for insurance, interest, rent, taxes, unused royalties, advertising services, and operating supplies.

You should classify an asset as current when an entity expects to sell or consume it during its normal operating cycle or within 12 months after the reporting period. If the operating cycle is longer than twelve months, then use the longer period to judge whether an asset can be classified as current. You should classify all other assets as non-current.

You should classify all of the following as current liabilities:

- *Payables*. All accounts payable incurred in the acquisition of materials and supplies that are used to produce goods or services.
- *Prepayments*. Amounts collected in advance of the delivery of goods or services by the entity to the customer. Do not include a long-term prepayment in this category.
- *Accruals*. Accrued expenses for items directly related to the operating cycle, such as the accruals for compensation, rentals, royalties, and various taxes.
- *Short-term debts*. Debts maturing within the next 12 months.

What Line Items Do I Include in the Income Statement? 9

You should classify a liability as current when the entity expects to settle it during its normal operating cycle or within 12 months after the reporting period, or if it is scheduled for settlement within 12 months. You should classify all other liabilities as non-current.

Current liabilities include accruals for amounts that can only be determined approximately, such as bonuses, and where the payee to whom payment will be made cannot initially be designated, such as a warranty accrual.



Can I Offset Information in the Balance Sheet?

Offsetting involves reporting only the net amount of an asset and a liability in the balance sheet. Generally, it is improper to do so unless there is a *right of setoff*. A right of setoff is a debtor's legal right to discharge all or some portion of the debt owed by another party by applying the debt against an amount that the other party owes to the debtor. If a right of setoff exists, generally accepted accounting principles (GAAP) generally allows offsetting in the balance sheet only if there are just two parties involved.

There is a right of setoff when each party owes the other party a determinable amount, the reporting party has the right to set off the amount owed with the amount owed by the other party, the reporting party intends to set off the amounts, and the reporting party's setoff right is legally enforceable.



What Line Items Do I Include in the Income Statement?

You should present all items of income and expense for the reporting period in a statement of comprehensive income. Alternatively, you can split this information into an income statement and a statement of comprehensive income.

There are no specific requirements for which line items are included in the income statement, but the following line items are typically used, based on general practice:

- Revenue
- Tax expense
- Post-tax profit or loss for discontinued operations and for the disposal of these operations
- Profit or loss
- Extraordinary gains or losses
- Other comprehensive income, subdivided into each component thereof
- Total comprehensive income

10 Financial Statements Presentation

A key additional item is to present an analysis of the expenses in profit or loss, using a classification based on their nature or functional area, maximizing the relevance and reliability of presented information. If you elect to present expenses by their nature, the format looks similar to the following:

Revenue	XXX
Expenses:	
Change in finished goods inventories	XXX
Raw materials used	XXX
Employee benefits expense	XXX
Depreciation expense	XXX
Telephone expense	XXX
Other expenses	XXX
Total expenses	XXX
Profit before tax	XXX

Alternatively, if you present expenses by their functional area, the format looks similar to the following:

Revenue	XXX
Cost of sales	XXX
Gross profit	XXX
Administrative expenses	XXX
Distribution expenses	XXX
Research and development expenses	XXX
Other expenses	XXX
Total expenses	XXX
Profit before tax	XXX

Of the two methods, presenting expenses by their nature is easier, since it requires no allocation of expenses between functional areas. Conversely, the functional area presentation may be more relevant to users of the information, who can more easily see where resources are being consumed.

You should add additional headings, subtotals, and line items to the items noted above if doing so will increase a user's understanding of the entity's financial performance.

What Line Items Do I Include in the Income Statement? 11

EXAMPLE 1.4

Plasma Storage Devices presents its statement of financial position in two statements by their nature, resulting in the following format, beginning with the income statement:

PLASMA STORAGE DEVICES INCOME STATEMENT FOR THE YEARS ENDED DECEMBER 31

(000s)	20x2	20x1
Revenue	\$ 900,000	\$ 850,000
Other income	25,000	20,000
Changes in finished goods inventories	(270,000)	(255,000)
Raw materials used	(90,000)	(85,000)
Employee benefits expense	(180,000)	(170,000)
Depreciation and amortization expense	(135,000)	(125,000)
Impairment of property, plant, and equipment	0	(50,000)
Other expenses	(75,000)	(72,000)
Finance costs	(29,000)	(23,000)
Profit before tax	146,000	90,000
Income tax expense	(58,000)	(32,000)
Profit for the year from continuing operations	88,000	58,000
Loss for the year from discontinued operations	(42,000)	0
Profit for the Year	\$ 46,000	\$ 58,000
Earnings per share:		
Basic	\$ 0.13	\$ 0.16
Diluted	0.09	0.10

Plasma Storage Devices then continues with the following statement of comprehensive income:

PLASMA STORAGE DEVICES STATEMENT OF COMPREHENSIVE INCOME

(000s)	20x2	20x1
Profit for the year	\$ 46,000	\$ 58,000
Other comprehensive income:		
Exchange differences on translating foreign operations	5,000	9,000
Available-for-sale financial assets	10,000	(2,000)
Actuarial losses on defined benefit pension plan	(2,000)	(2,000)
Other comprehensive income, net of tax	13,000	5,000
TOTAL COMPREHENSIVE INCOME	59,000	63,000

12 Financial Statements Presentation



How Do I Account for Extraordinary Items?

An extraordinary item is an event or transaction that is distinguished by both its unusual nature and the infrequency of its occurrence. Something is considered to be unusual if it represents a high degree of abnormality and is unrelated to an entity's typical activities. Something occurs infrequently if you do not reasonably expect it to recur in the foreseeable future.

Examples of extraordinary items are:

- A tornado destroys crops in an area where tornado damage is rare.
- An earthquake destroys a building.
- A hurricane destroys a business in an area where there is no record of hurricane damage.

Items that are *not* considered to be extraordinary are:

- Adjustments to accruals on long-term contracts
- Asset disposal gains or losses
- Effects of a strike
- Foreign currency transaction gains or losses (including currency devaluations and revaluations)
- Remaining excess of the fair value of acquired net assets over cost
- Write-downs of accounts receivable, inventory, deferred research and development costs, and other intangible assets

The following are examples of events that are not extraordinary:

- A farmer's grapes are destroyed by frost in an area where frost damage is relatively common.
- A company is unable to complete a public equity registration.
- A company incurs costs to defend itself from a hostile takeover.

If you classify an item as extraordinary, then classify it separately in the income statement if it is material in relation to the income before extraordinary items, or to the trend of annual earnings before extraordinary items. You should make this decision for individual items, and not in aggregate for multiple items.

Extraordinary items should be segregated from the results of ordinary operations and shown separately in the income statement, using the following format:

What Are the Main Components? 13

Income before extraordinary items	\$XXX,XXX
Extraordinary items (less applicable taxes of \$___) (Note XX)	<u>X,XXX</u>
Net income	<u>\$XXX,XXX</u>

In the accompanying notes to the financial statements, disclose the nature of the extraordinary event and the principal items entering into its determination as an extraordinary item, as well as the related amount of income taxes. Also, if earnings per share disclosure are required, then separately disclose the earnings per share for extraordinary items.



What Line Items Do I Include in the Statement of Changes in Equity?

You should include the following line items in the statement of changes in equity:

- Total comprehensive income (with separate presentation of the amounts attributable to the owners of the parent entity and to non-controlling interests)
- Effects of retrospective applications or restatements on each component of equity (which are usually adjustments to the opening balance of retained earnings)
- Reconciliation of changes during the period for each component of equity resulting from profit or loss, each item of other comprehensive income, and transactions with owners (including contributions by and distributions to them)
- Dividends recognized, and the related amount per share (this item can alternatively be presented in the associated notes)



What Are the Main Components of the Statement of Cash Flows?

The statement of cash flows contains information about activities that generate and use cash. The primary activities are:

- *Operating activities.* These are an entity's primary revenue-producing activities. Examples of operating activities are cash receipts from the sale of goods, as

EXAMPLE 1.5

Musical Heritage Company presents its statement of changes in equity as follows to reflect changes in its equity over a two-year period:

	Share Capital:	Retained Earnings	Total	Non-Controlling Interests	Total Equity
Balance at Jan. 01, 20x1	\$350,000	\$50,000	\$400,000	\$40,000	\$440,000
Accounting policy change	—	(3,000)	(3,000)	—	(3,000)
Restated balance	350,000	47,000	397,000	40,000	437,000
Changes in equity for 20x1					
Dividends	—	(25,000)	(25,000)	—	(25,000)
Total comprehensive income	—	42,000	42,000	4,000	46,000
Balance at Dec. 31, 20x1	350,000	64,000	414,000	44,000	458,000
Changes in equity for 20x2					
Dividends	—	(18,000)	(18,000)	—	(18,000)
Issue of share capital	125,000	—	125,000	—	125,000
Total comprehensive income	—	37,000	37,000	4,000	41,000
Balance at Dec. 31, 20x2	\$475,000	\$83,000	\$558,000	\$48,000	\$606,000

What Are the Direct and Indirect Method? 15

well as from royalties and commissions, amounts received or paid to settle lawsuits, fines, payments to employees and suppliers, cash payments to lenders for interest, contributions to charity, and the settlement of asset retirement obligations.

- *Investing activities.* These involve the acquisition and disposal of long-term assets. Examples of investing activities are cash receipts from the sale of property, the sale of debt or equity instruments of other entities, and repayment of loans made to other entities. Examples of cash payments that are investment activities include the acquisition of property, plant, and equipment, and purchases of the debt or equity of other entities.
- *Financing activities.* This refers to those activities resulting in alterations to the amount of contributed equity and the entity's borrowings. Examples of financing activities include cash receipts from the sale of the entity's own equity instruments or from issuing debt, proceeds received from derivative instruments, as well as cash payments to buy back shares, pay dividends, and to pay off outstanding debt.

The statement of cash flows also incorporates the concept of *cash and cash equivalents*. A cash equivalent is a short-term, very liquid investment that is easily convertible into a known amount of cash, and which is so near its maturity that it presents an insignificant risk of changes in value because of changes in interest rates.



What Are the Direct and Indirect Method Layouts for the Statement of Cash Flows?

You can use the *direct method* or the *indirect method* to present the statement of cash flows. The direct method presents the specific cash flows associated with items that affect cash flow. Items typically affecting cash flow include:

- Cash collected from customers
- Interest and dividends received
- Cash paid to employees
- Cash paid to suppliers
- Interest paid
- Income taxes paid

Under the indirect method, the presentation begins with net income or loss, with subsequent additions to or

16 Financial Statements Presentation

deductions from that amount for non-cash revenue and expense items, resulting in net cash provided by operating activities.

Examples of both methods are located in the answer to the next question.



What Line Items Should I Include in the Statement of Cash Flows?

The statement of cash flows reports cash activities during a reporting period, subdivided into operating, investing, and financing activities. The information you should include in these activities is as follows:

- *Operating activities.* Use either the direct method (disclosing major classes of gross cash receipts and payments) or the indirect method (adjusting profit or loss for changes in inventories, receivables, payables, and a variety of non-cash items).
- *Investing activities.* Separately report the major classes of gross cash receipts and payments caused by investing activities. You should separately report investing cash inflows and outflows; for example, a payment for property, plant, and equipment is reported separately from a receipt from the sale of property, plant, and equipment.
- *Financing activities.* Separately report the major classes of gross cash receipts and payments caused by financing activities.

Examples of the direct method and indirect method of presenting a statement of cash flow follow.

EXAMPLE 1.6

Ajax Machining Company constructs the following statement of cash flows using the direct method:

AJAX MACHINING COMPANY STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 12/31/X1

Cash flows from operating activities

Cash receipts from customers	\$45,800,000
Cash paid to suppliers	(29,800,000)
Cash paid to employees	(11,200,000)
	4,800,000

What Line Items Should I Include? 17

Interest paid	(310,000)	
Income taxes paid	(1,700,000)	
<i>Net cash from operating activities</i>		<u>\$2,790,000</u>
Cash flows from investing activities		
Purchase of property, plant, and equipment	(580,000)	
Proceeds from sale of equipment	110,000	
<i>Net cash used in investing activities</i>		<u>(470,000)</u>
Cash flows from financing activities		
Proceeds from issuance of common stock	1,000,000	
Proceeds from issuance of long-term debt	500,000	
Principal payments under capital lease obligation	(10,000)	
Dividends paid	(450,000)	
<i>Net cash used in financing activities</i>		<u>1,040,000</u>
Net increase in cash and cash equivalents		<u>3,360,000</u>
Cash and cash equivalents at beginning of period		<u>1,640,000</u>
Cash and cash equivalents at end of period		<u><u>\$5,000,000</u></u>

Reconciliation of net income to net cash provided by operating activities:

Net income		\$2,665,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	\$125,000	
Provision for losses on accounts receivable	15,000	
Gain on sale of equipment	(155,000)	
Increase in interest and income taxes payable	32,000	
Increase in deferred taxes	90,000	
Increase in other liabilities	18,000	
Total adjustments		<u>125,000</u>
Net cash provided by operating activities		<u>\$2,790,000</u>

18 Financial Statements Presentation

EXAMPLE 1.7

Eagle Construction Company constructs the following statement of cash flows using the indirect method:

**EAGLE CONSTRUCTION COMPANY STATEMENT OF
CASH FLOWS FOR THE YEAR ENDED 12/31/X1**

Cash flows from operating activities

Net income		\$3,000,000
Adjustments for:		
Depreciation and amortization	\$125,000	
Provision for losses on accounts receivable	20,000	
Gain on sale of facility	(65,000)	
		<u>80,000</u>
Increase in trade receivables	(250,000)	
Decrease in inventories	325,000	
Decrease in trade payables	(50,000)	
		<u>25,000</u>
<i>Cash generated from operations</i>		3,105,000

Cash flows from investing activities

Purchase of property, plant, and equipment	(500,000)	
Proceeds from sale of equipment	35,000	
		<u>(465,000)</u>
<i>Net cash used in investing activities</i>		(465,000)

Cash flows from financing activities

Proceeds from issue of common stock	150,000	
Proceeds from issuance of long-term debt	175,000	
Dividends paid	(45,000)	
		<u>280,000</u>
<i>Net cash used in financing activities</i>		280,000

Net increase in cash and cash equivalents 2,920,000

Cash and cash equivalents at beginning of period 2,080,000

Cash and cash equivalents at end of period \$5,000,000

Cash paid during the year for:

Interest (net of amount capitalized)	\$ 100,000
Income taxes	420,000

When Should I Report Discontinued Operations? 19

You should disclose the following items related to the statement of cash flows:

- *Cash equivalents.* The policy for determining which items are treated as cash equivalents.
- *Interest and taxes paid.* If you use the indirect method of reporting cash flows, then disclose the amounts of interest paid, net of any amounts capitalized, and income taxes paid during the period.
- *Investing and financing activities.* The investing and financing activities affecting recognized assets or liabilities, but which do not result in cash receipts or payments during the period. Examples are the conversion of debt to equity, acquiring assets by assuming related liabilities, exchanging non-cash assets for other non-cash assets, and obtaining an asset by entering into a lease. This disclosure can be in the financial statements or in the accompanying notes.



When Should I Report Discontinued Operations?

You should separately report the results of the operations of a component of an entity if it has either been disposed of or is classified by the entity as held for sale. More specifically, a discontinued operation is one where the operations and cash flows of the operation either have been or will be eliminated from the ongoing operations of the entity, and the entity will not have any significant continuing involvement in its operations after the disposal is complete. An example of the presentation of a discontinued operation follows:

EXAMPLE 1.8	
Income from continuing operations before income taxes	\$100,000
Income taxes	(30,000)
Income from continuing operations	\$70,000
Discontinued operations	
Loss from operations of discontinued business component	(15,000)
Income tax benefit	<u>5,000</u>
Loss on discontinued operations	<u>(10,000)</u>
Net income	<u><u>\$60,000</u></u>

20 Financial Statements Presentation

If there is a recognized loss on the disposal of a discontinued operation, then disclose it either on the face of the income statement or in accompanying notes.

If you adjust an amount previously reported in discontinued operations, and that is directly related to the disposal of an entity component from a prior period, then classify it separately in the current period, within discontinued operations. Such a situation may arise when an entity resolves contingencies related to the terms of a disposal transaction.

You should also allocate to discontinued operations the interest on any debt to be assumed by the buyer, as well as any debt that is to be repaid as a result of the disposal transaction.

Do not allocate general corporate overhead to a discontinued operation.



What Information Should I Disclose about Discontinued Operations?

If you have a component of an entity that is a discontinued operation (see the criteria for a discontinued operation in the answer to the last question), then present the assets and liabilities associated with the discontinued operation separately in the asset and liability sections of the statement of financial position. Do not offset and present them as a single line item. In addition, present the major classes of these assets and liabilities either on the face of the statement of financial position, or in the accompanying notes.

In addition to the above information, present the following items in the notes to the financial statements:

- *Adjustments.* The nature and amount of adjustments made to amounts that were previously reported in discontinued operations.
- *Cash flows.* If the segment generates continuing cash flows, then disclose the nature of the activities causing the cash flows, the time period over which cash flows are expected to continue, and the main factors used to decide that the expected cash flows are not direct cash flows of the disposal group.
- *Facts and circumstances.* The facts and circumstances leading to the expected disposal, and the manner and timing of the disposal.
- *Gain or loss.* The gain or loss recognized on the discontinuance.

- *Segment*. The segment in which the disposal group is reported.
- *Taxes*. The amounts of revenue and pretax profit or loss reported for the discontinued operation.



What Accounting Policies Should I Disclose with the Financial Statements?

You should disclose those accounting policies followed by the entity that materially affects the determination of its financial position, cash flows, or results of operations. The disclosure should include all situations where there are several alternative policies available, any unusual or innovative applications of GAAP, or methods peculiar to a specific industry in which the entity operates. Examples of policies typically disclosed are:

- Amortization of intangibles
- Basis of consolidation
- Depreciation methods
- Inventory pricing
- Profit recognition on long-term construction contracts
- Revenue recognition related to franchising and leasing operations



What Information About Risks and Uncertainties Should I Disclose in the Financial Statements?

You include the following information about risks and uncertainties in the notes accompanying the financial statements:

- *Nature of operations*. Describe the entity's major products or services and the locations of the markets in which the entity conducts its sales. If the entity reports more than one business, then indicate the relative importance of its operations in terms of their assets, revenues, or earnings.
- *Use of estimates*. Explain that management used some estimates to prepare financial statements in accordance with generally accepted accounting principles.
- *Significant estimates*. Discuss those estimates and contingencies for which it is reasonably possible that the estimates will change in the near term, and the effect of the change will be material. If the estimate

22 Financial Statements Presentation

involves a loss contingency, disclose an estimate of the possible loss or range of loss, or state that you cannot make this estimate. An example of an area in which estimates change frequently is when technological advances increase the rate of obsolescence of inventory and specialized equipment.

- *Concentrations.* Disclose any vulnerability to which the entity is exposed, as a result of excessive concentrations of activity with certain business partners, products, supplies, or markets. This disclosure is necessary only if the concentration exists as of the date of the financial statements, the concentration risk can result in a severe impact to the entity, and it is at least reasonably possible that the severe impact could occur in the near term.



How Frequently Should I Issue Financial Statements?

An entity should issue a complete set of financial statements at least once a year. If it changes the end of its reporting period, so that the current year is less or longer than 12 months, you should disclose the reason for the altered period and state that the amounts included in the financial statements are not entirely comparable with those of previous years.



How Consistent Should the Financial Statement Presentation Be?

You should retain the presentation and classification of items shown in the financial statements across all presented periods. The exceptions are when GAAP requires a presentation alteration, or when a significant change in an entity's operations makes a different presentation more appropriate. If the latter is the reason, then you should only do so if the significant change is likely to continue into the future.



How Do I Aggregate Information in the Financial Statements?

You should separately present each material class of similar items. Conversely, do not aggregate items of a dissimilar nature, unless they are immaterial. If an item is not material enough to be separately presented in the financial statements, you may still consider separate presentation in the accompanying notes.



Is the Accrual Basis of Accounting Required?

Yes. Under the accrual method of accounting, record revenues and expenses when they are incurred, irrespective of when cash is exchanged.



Can I Offset Assets and Liabilities or Revenues and Expenses?

Not unless specifically authorized by GAAP, which is typically only for a very restricted application. In nearly all situations, you should separately report assets and liabilities, as well as revenues and expenses. If you engage in offsetting these accounts, it detracts from the ability of users to understand the underlying transactions and to assess the entity's future cash flows.

You are not offsetting when you measure assets' net of valuation allowances, which is a common and acceptable practice for accounts receivable and inventory.



What Are Consolidated Financial Statements?

Consolidated financial statements are the financial statements of a group of entities that are presented as being those of a single economic entity. A *group* is a parent entity and all of its subsidiaries. A *subsidiary* is an entity that is controlled by a parent entity. Consolidated financial statements are presumed to be more meaningful than separate financial statements.



When Must a Parent Include Another Entity in its Financial Statements?

Consolidated financial statements must include all of the subsidiaries of the parent entity. These subsidiaries are entities over which the parent entity has:

- More than half of the outstanding voting shares of the entity (unless such ownership does not constitute control)
- The power to control through a lesser percentage of ownership, such as through a contract, agreement with other stockholders, or court decree

A parent entity must include a subsidiary in its consolidated financial statements, even if the subsidiary's

24 Financial Statements Presentation

business activities are not similar to those of the other subsidiaries whose results are included in the consolidated financial statements.



What Is the Process for Consolidating Financial Statements?

The general process for consolidating the financial statements of a parent entity and its subsidiaries is to combine the statements line by line. More specifically, the following eight steps are to be applied:

1. Adjust the financial statements of any member of the group to conform to the accounting policies used by the parent for consolidating the financial statements.
2. Make adjustments for the effects of significant transactions or events occurring between the dates of the financial statements of the subsidiaries and the parent, if they differ.
3. Eliminate all intra-group balances, transactions, incomes, and expenses. This includes the elimination of profits and losses resulting from intra-group transactions.
4. Eliminate the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary.
5. Identify non-controlling interests in the profit or loss of consolidated subsidiaries.
6. Separately identify the non-controlling interests in the net assets of the consolidated subsidiaries. These non-controlling interests include the amount of non-controlling interests at the date of the original combination and the non-controlling interests' share of any changes in equity since the date of combination.
7. Present non-controlling interests in the consolidated statement of financial position within equity, separately from the equity of the parent entity's owners.
8. Attribute profit or loss and other comprehensive income to the parent entity and to non-controlling interests.



As of What Date Do I Include the Revenues and Expenses of an Acquired Subsidiary?

You should include the revenues and expenses of a newly-acquired subsidiary in the consolidated financial

statements of the parent entity beginning on the acquisition date.



What if the Fiscal Year-End of a Parent Is Different from That of a Subsidiary?

If the subsidiary cannot prepare financial statements for consolidation purposes that correspond to those of the parent company, then it is acceptable to use the annual results of the subsidiary for a different fiscal year, as long as the difference is not more than three months. If there is such a difference, then you should disclose the effect of any intervening events that would materially affect the entity's financial position or results of operations.



What Happens to a Consolidation if You Lose Control of a Subsidiary?

If the parent entity loses control of a subsidiary, it should deconsolidate the subsidiary as of the date when the parent no longer has a controlling financial interest in the subsidiary.



What Information Should I Disclose about Consolidated Financial Statements?

The parent entity should disclose the following information in its consolidated financial statements:

- *Consolidation policy.* The policy followed for consolidating financial statements.
- *Less than wholly-owned subsidiary.* If the parent has a less than wholly-owned subsidiary, it should disclose the amounts of consolidated net income and consolidated comprehensive income and their attribution, as well as the amounts attributable to the parent for income from continuing operations, discontinued operations, and extraordinary items. Also, disclose a reconciliation of the equity changes attributable to the parent and the non-controlling interest.
- *Loss of control.* The gain or loss recognized upon loss of control in a subsidiary, the portion of that amount attributable to recognizing investments retained in the subsidiary at its fair value, and the line item where the gain or loss is recognized in the income statement.

<http://www.pbookshop.com>